TOPICS: Corporate Governance, ESG, Spotlight, Strategy

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What Should Boards Do to Ensure ESG Accountability?

By Gregg H. Passin

Long before the pandemic, US companies were addressing and grappling with environmental, social, and governance (ESG) issues and the impact of climate change on their businesses. In addition, the Black Lives Matter and #MeToo movements have brought issues of diversity, equity, and inclusion (DE&I) front and center for organizations, and the Great Resignation and war for talent have highlighted the need for companies to strengthen their employee value propositions and more fully monitor their human capital.

Research for Mercer's latest iteration of the Global Talent Trends study covering attitudes on workplace issues continues to show that employees who thrive want and expect to work at companies that make a positive mark on society.

As ESG imperatives have become more widely discussed, organizations have started considering how best to hold themselves accountable. One way to accomplish this is to tie leaders' compensation to positive ESG outcomes, but few US companies have done this—until now.

In 2021, Mercer research found that for the first time, more than 50 percent of S&P 500 companies included ESG metrics of some type in their incentive compensation programs for top executives. So far in 2022, Mercer's research on companies that have released proxy statements suggests this statistic could rise to close to 70 percent of S&P 500 companies (with many smaller companies doing this as well).

So, what should boards do to hold their organizations—and themselves—appropriately accountable through incentive compensation? Following these four steps will help directors form the right approach for their organizations:

1. **Responsibility: Decide whether the full board or a board committee is responsible for overseeing ESG accountability.** In some organizations, broad ESG and sustainability responsibility lies with the full board. Some companies assign DE&I and human capital management issues to the compensation/human resources committee and sustainability oversight to audit or governance committees. The exact assignments will vary with each company's specific needs and culture, but it is critical to assign accountability and ensure sufficient governance oversight actions and appropriate interventions.
2. **Strategy and Culture: Ensure the company has a robust ESG strategy, including specific strategies for sustainability, DE&I, and human capital management.** Before an incentive compensation program can be designed appropriately, organizations must determine and clearly communicate their strategy and objectives in each area. For example, what does the organization want to accomplish and over what time frame? As with any other incentive plan metric, the company needs to be able to measure ESG—and its constituent parts—by identifying the key desired outcomes and understanding where the organization is today for each area. You need to know where the organization is starting from, where it wants to go, and how it's going to get there. You also must examine the current data, benchmarks, and goals to set a baseline from which to improve and then define how to quantify the current state, goals, and progress along the way. Equally important is setting the company up for success by creating a culture that will support change in each area of ESG. This means lining up authentic support from leaders at all levels, including the entire board, and other company stakeholders.
3. **Design: Decide on the right incentive compensation plan design.** There are many decisions to make in designing an incentive compensation plan. The most critical ones for a plan with ESG metrics include:
    - **The ESG metrics themselves.** ESG metrics will differ by company and need to be tied to the overall ESG strategy. Note that it's impossible to capture all sustainability, DE&I, and human capital management metrics in your incentive plans. The board must work with management to determine the most critical metrics and how to demonstrate success.
    - **Goals.** Once metrics are decided, setting actual goals comes next. Goals can be set and articulated qualitatively, allowing the board a degree of discretion, or quantitatively, setting specific threshold, target, and maximum goals and related payouts. Our research shows that most public companies use qualitative goals with human capital and DE&I-related measures, but quantitative goals with sustainability and environmental measures.
    - **Weighting.** How prominent should ESG be in the incentive compensation schema? ESG metrics tend to be weighted from 5 percent to no more than 10 percent of total incentive opportunity, but we expect that to increase modestly over time.
    - **Time frame.** Will the ESG metrics be in the company's annual short-term incentive plan or in the long-term incentive plan, measuring results over a three- or four-year period? While ESG accomplishments are typically longer-term in nature, most companies use their short-term plan to reward ESG performance. However, we are seeing some companies using their long-term incentive plans to measure ESG and DE&I and expect that trend to continue as companies become more familiar with ESG metrics.

4. **Accountability: Agree on whose pay in the organization is going to be subject to ESG performance.** Many companies start with their C-suite and other senior executives. But boards should oversee decisions about who else should be held accountable for ESG performance, especially when most action on ESG issues takes place deeper in the organization.

While directors don't receive incentive-based compensation for their service, the board should measure its own performance in overseeing the company's ESG strategy and progress to make sure it is also held accountable for ESG success.

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